

Telecom entities have no obligation to withhold tax on discounts offered through distributors

By: Ravi S. Raghavan, Partner, Tax and Private Client Group, Majmudar & Partners, India

Overview

In a recent ruling in the *Bharti Cellular Limited* case (the “**Taxpayer**”), India’s Supreme Court has held that because a “principal-agent” relationship does not exist between the Taxpayer and the distributor, the discounts offered by the Taxpayer on SIM cards and recharge coupons to distributors in a prepaid connection business model are not in the nature of commission payments and, therefore, do not attract the withholding tax provisions under Indian tax law.

Background

The Taxpayer offered both, prepaid and postpaid connections to the end user. The ruling concerns the “prepaid connection business model” wherein an end user pays for the services in advance by purchasing a prepaid product from a distributor. The way it typically works is that the Taxpayer enters into a franchise agreement with the distributor and sells the prepaid products at a discount over the printed price. The distributor then sells the prepaid products to end users at any price but not exceeding the printed price. The Indian tax authorities viewed the income (i.e., the difference between the discounted price paid to the Taxpayer and the final sale consideration received from end user) of the distributor as “commission/brokerage” paid by the Taxpayer to the distributor in the capacity of an agent. As a result, it was alleged that the Taxpayer failed to deduct tax on such commission payments under section 194H of the Income-tax Act, 1961 (the “**IT Act**”).

Section 194H of the IT Act casts an obligation on a payer to withhold tax at source at the rate of 5% on payment or credit of an income by way of commission or brokerage to a resident. The term “commission or brokerage” is defined to include payments received or receivable, directly or indirectly, by persons acting on behalf of another person and rendering services in the course of buying or selling any asset (excluding securities).

Given the divergent views expressed by High Courts, various petitions were filed before the Supreme Court.

Supreme Court’s ruling

On the basis of the provisions contained in Section 182 of the Indian Contract Act, 1872, the Supreme Court explained that an agent transacts in goods on behalf of the principal, whereas an independent contractor sells goods as his own. In an agency relationship, the transferee will be a debtor to the principal and not the agent. The sale proceeds received by an independent distributor belong to him exclusively. Further, as an independent distributor sells goods on his own account, the end customer may only hold the

independent distributor liable for any breach of contractual obligations. In an agency relationship, however, the end customer can hold the agent as well as the principal liable. An independent contractor generally works towards maximizing his profits, whereas an agent is generally entitled to a prearranged remuneration. Furthermore, a distributor's obligations to the principal are only limited to the specific contractual terms, whereas an agent has additional obligations due to a fiduciary relationship (for example, obligation to render accounts).

Based on the franchise agreement between the Taxpayer and the distributor, the Supreme Court held that the obligations outlined in the contract did not exhibit fiduciary characteristics and did not indicate that the business conducted by distributor was on behalf of the principal. Though the discounted price was fixed or negotiated between the Taxpayer and the distributor, the sale price received by the distributor was at the sole discretion of the distributor. The Taxpayer had no control on the sale price that was charged by the distributor.

The income of the distributor, being the difference between sale price received by the distributor and the discounted price, was paid or credited to the account of the distributor when the SIM card was sold to the end-user. The sale price and the income of the distributor accrued only through an arrangement between the distributor and the ultimate end user. Accordingly, the Taxpayer was not involved in paying or crediting the account of the distributor with commission or brokerage income on which tax was to be deducted under Section 194H of the IT Act. Therefore, no tax was deductible.

Our comments

The Supreme Court's decision is important as it has decided on an issue on which there were divergent views of various High Courts. The Delhi and Calcutta High Courts had held that the assesseees were liable to deduct tax at source under Section 194H of the IT Act, whereas the Rajasthan, Karnataka and Bombay High Courts had held that tax withholding provisions were not attracted.

The ruling is of relevance to taxpayers with similar business models, who may need to review and reassess their strategy depending on the terms of their arrangements with distributors. Interestingly, the Supreme Court has held that the Indian tax authorities should interpret "tax deduction provisions" realistically and not adopt a "catch-as-catch can" approach. When there is an apparent divergence of opinion, to avoid litigation, it may be advisable for the Central Board of Direct Taxes to clarify doubts by issuing appropriate instructions/ a circular after ascertaining views of the stakeholders. In addition to enhancing revenue and ensuring tax compliance, an equally important facet is to reduce litigation.

